COMPENSATION

PLAYS FOR PAY

In the era of say on pay, a company's long-term incentive alternatives might seem limited, but there is room for tailoring plans—and even bringing options back into the mix.

BY C.J. PRINCE

IN THE LATE '90s and early 2000s, most long-term incentive (LTI) compensation plans began and ended with stock options. If CEOs were rewarded for a bump in share price, it stood to reason they'd do whatever was necessary to get there. In a ballooning market, stocks, company prospects and CEO pay all fared well, and everyone was happy.

Then came the dot-com crash, after which options came under fire for fueling frenzied, short-term strategies and risky behavior. Even so, they remained prevalent. As recently as 2010, three-quarters of top 250 companies used options, according to data from FW Cook, an independent compensation consultancy based in New York City.

Enter say on pay. The groundswell of support for proxy voting on executive compensation reached a crescendo in 2011, when Congress enacted a mandatory, though non-binding, shareholder vote on executive pay. "That's where we saw companies move toward this homogenized model in response to the 'best practices' as qualified by proxy advisory firms," says Charley King, managing director at FW Cook.

According to new research by FW Cook, the current average mix for CEO LTI plans among the top 250 companies is 56 percent in performance awards, 23 percent in stock options and stock appreciation rights (SARs) and 21 percent in restricted stock—and there doesn't appear to be a lot of deviation from that mix.

"There's a natural tendency to stay within the guardrails," says King. "Comp committees are coming to the table with a level of anxiety that's apparent. You don't want, on your watch, your company getting into the crosshairs of a say on pay issue."

Yet, there are ways to customize LTI plays without running afoul of say on pay, says King, who outlines three:

Moving away from relative TSR. Following say on pay, relative total shareholder return (TSR) became the metric of choice for most top 250 companies. But some companies, while keeping performance awards at 50 percent of the total, are changing the weighting of metrics to reduce the emphasis on relative TSR and boost other shareholder-friendly metrics. Citigroup, for example, recently announced that it is replacing relative TSR with "return on tangible common equity" and "cumulative EPS" because, "during our stockholder outreach efforts, we heard little support for retaining a standalone performance metric based on TSR." Nearly all of Citigroup's investors said they preferred operational, metric-based incentives because operational results were "more directly influenced by management's decisions than TSR." Moreover, TSR is a backward-looking metric that measures return to shareholders, but doesn't necessarily drive it.

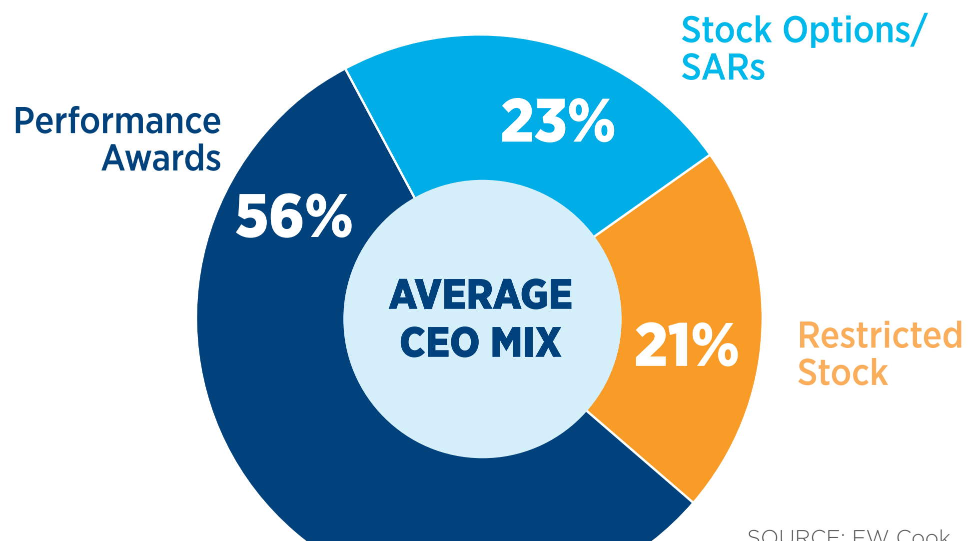
> **"Stock options use has declined and continues to trail restricted stock use."**

Citigroup's board elected to keep TSR as a modifier that would cap the performance-based award at target if total shareholder return is negative over the three-year period. In other words, TSR can now only reduce, rather than increase, the value of performance awards.

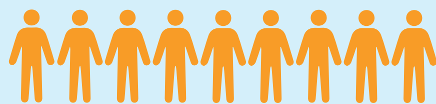
"The Citigroup example demonstrates that you can replace TSR with something much more tangible to the executive team

LONG-TERM INCENTIVE MIX

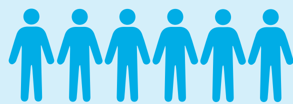
56% of top companies use performance awards.



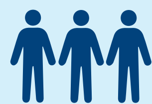
PREVALENCE OF LONG-TERM INCENTIVE GRANT TYPES



95% Performance Awards



65% Restricted Stock



59% Stock Options

SOURCE: FW Cook

and which gives them a better line of sight to how they can affect those outcomes three years later," says King. Apple, International Paper, UPS, MetLife, Lockheed Martin and Occidental Petroleum are also limiting payout of performance stock units to 100 percent of target—even if companies beat their peers—if absolute TSR is negative.

Adding stock options back in. Contrary to the rumors, stock options are not dead. Used strategically in concert with other performance-based rewards, options can not only align pay with performance but let the Street know a company is repositioning itself as a growth company. Last year, General Motors announced it would replace time-based restricted stock with stock options "as a way to further align our most senior leaders with shareholder interests."

Beverage company Constellation Brands offers executives an LTI mix that is 50 percent stock options, double what other industry companies are doing. The move serves to differentiate the company from rivals and stimulate innovation.

In another example, a Fortune 500 healthcare company had long ago dispensed with stock options because it believed they'd fallen out of favor. But King suggested the board's comp committee reconsider adding them to the mix. "I said, 'You have made transformational acquisitions the last few years, you've diversified the business and you've created a growth story. Why don't we consider adding stock options back?'

"Initially, there was a surprised reaction," he recalls. But he then explained the options would be weighted at just 20 percent of the total. "They still had a program using three-year performance shares, measuring EPS growth and revenue, and they still had a portion of time-based restricted stock that gave them that retention value." Options would complement these other elements of LTI pay, providing leverage and greater shareholder alignment. Ultimately, the board decided to do it, and the result has been a net positive.

Another variation on the standard is the use of premium-priced options, considered a performance-based award so long as the premium is greater than 10 percent. But boards need to be careful about valuation; IBM's one-time, 1.5 million grant of premium-priced options to CEO Ginni Rometty in January 2016 raised ire over option prices ISS viewed as too low.

Using non-financial metrics. Restricted stock that rewards the achievement of operational goals, such as return on equity, return on assets or return on capital are also gaining favor. In 2010, 31 percent of companies offered LTI grants for capital efficiency; by 2017, that number had climbed to 41 percent. Capital-intensive industrial companies use the return-on-capital metric more often. Of the 31 industrials in FW Cook's top 250 companies, 24 used some form of efficiency metric.

However, companies using ROIC need to be aware that M&A in a given year can throw ROIC measurements out of whack, notes Erin Bass-Goldberg, FW Cook managing director.

Strategic goals can also encompass intangibles. For example, Delta Airlines measures and rewards the delivery of outstanding customer service.

"Companies have struggled with non-financial goals because sometimes the measurement can be more challenging," says Bass-Goldberg. "But if you think about it, linking pay to significant strategic initiatives makes perfect sense. If the executive achieves the initiatives, value creation will follow." **CBM**

LONG-TERM INCENTIVE METRICS

60% of companies with performance plans use TSR as a performance metric; 90% of TSR usage is on a relative basis, with another 8% on both a relative and absolute basis.

SOURCE: FW Cook

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